

Internal Revenue Service

Department of the Treasury

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October 01, 1999

Legend

X =

H =

W =

Trust H =

Trust W =

State =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

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This responds to the July 9, 1999 letter, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code that the termination of X's subchapter S election was inadvertent.

FACTS

X was incorporated under State law. Effective D1, X elected to be treated as a subchapter S corporation.

As of D1, H and W (husband and wife) were the only shareholders of X. On D2, H and W each transferred shares of X stock to trusts – Trust H and Trust W, respectively. X represents that Trust H and Trust W were grantor trusts and permissible S corporation shareholders under § 1361(c)(2)(A)(i).

On D3, W died. Upon W's death, Trust W became irrevocable and the entire corpus of the trust was includible in W's gross estate for federal tax purposes. At the time of W's death, Trust W held shares of X stock.

The administration of W's estate and of Trust W were closely related. For reasons detailed in the ruling request, administration of W's estate was delayed. Two years after W's death, on D4, Trust W still held shares of X stock.

In D5, while reviewing H's estate plan, counsel for H discovered that Trust W continued to hold X stock for more than two years after W's death and that as a result, X's S corporation election had terminated. Shortly after this discovery, on D6, X represents that the Trust W trustee distributed the shares of X stock held by Trust W to eligible S corporation shareholders.

Neither X nor its shareholders were aware that as of D4, Trust W no longer was an eligible S corporation shareholder. From D4 to D6, X and its shareholders treated Trust W as an eligible shareholder, and treated X as an S corporation. It was not part of a plan by X or any of its shareholders to terminate X's S election.

LAW AND ANALYSIS

Section 1361(a)(1) defines an "S corporation", with respect to any taxable year, as a small business corporation for which an election under § 1362(a) is in effect for that year.

Section 1361(b)(1)(B) provided that a "small business corporation" cannot have as a shareholder a person (other than an estate and other than a trust described in § 1361(c)(2)) who is not an individual.

Section 1361(c)(2)(A)(i) provides that a trust, all of which is treated

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(under subpart E, part I, subchapter J, chapter 1) as owned by an individual who is a citizen or resident of the United States, is a permitted shareholder of a small business corporation.

Section 1361(c)(2)(A)(ii) provided that, for purposes of § 1361(b)(1)(B), a trust that was described in § 1361(c)(2)(A)(i) immediately before the death of the deemed owner and that continues in existence after such death, is a permitted shareholder, but only for the 60-day period beginning on the day of the deemed owner's death. Further, if the entire corpus of the trust is includible in the gross estate of the deemed owner, the preceding sentence shall be applied by substituting "2-year period" for "60-day period". Section 1361(c)(2)(A)(ii).

Section 1362(d)(2)(A) provides that in general, an election under § 1362(a) shall be terminated whenever (at any time on or after the first day of the taxable year for which the corporation is an S corporation) the corporation ceases to be a small business corporation. The termination is effective on and after the day of the cessation. Section 1362(d)(2)(B)

Section 1362(f), in relevant part, provides that, if: (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2); (2) the Secretary determines that the circumstances resulting in such termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in such termination, steps were taken so that the corporation is a small business corporation; and (4) the corporation, and each person who was a shareholder in the corporation at any time during the period specified pursuant to this subsection, agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in such termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

The committee reports accompanying the Subchapter S Revision Act of 1982, in discussing § 1362(f) as it relates to inadvertent terminations, state, in part, as follows:

If the Internal Revenue Service determines that a corporation's subchapter S election is inadvertently terminated, the Service can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and the shareholders agree to be treated as if the election had been in effect for such period.

The committee intends that the Internal Revenue Service be reasonable in granting waivers, so that corporations whose subchapter S eligibility requirements have been inadvertently violated do not suffer the tax consequences of a termination if no tax avoidance would result from the continued subchapter S treatment. In granting a waiver, it is hoped the

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taxpayers and the government will work out agreements that protect the revenues without undue hardship to taxpayers It is expected that the waiver may be made retroactive for all years, or retroactive for the period in which the corporation again became eligible for subchapter S treatment, depending on the facts.

S. Rep. No. 640, 97th Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-24.

CONCLUSIONS

Based solely on the facts submitted and representations made, we conclude that X's subchapter S election terminated on D4 when the two-year period described in § 1361(c)(2)(A)(ii) expired. We also conclude that the termination was an inadvertent termination within the meaning of § 1362(f). Under the provisions of § 1362(f), X will be treated as an S corporation from D4 and thereafter, provided that X's S corporation election is not otherwise terminated under § 1362(d).

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Pursuant to the power of attorney on file with this office, a copy of this letter is being sent to X.

Sincerely,

Signed/Dianna K. Miosi
Dianna K. Miosi
Chief, Branch 1
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter

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